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TRANSCRIPT OF RECORD

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1942

No. 41

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

vs.

THE STRONG MANUFACTURING COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT

PETITION FOR CERTIORARI FILED MARCH 5, 1942
CERTIORARI GRANTED APRIL 6, 1942

SUPREME COURT OF THE UNITED STATES

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THE STRONG MANUFACTURING COMPANY

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1 Before United States Board of Tax Appeals

Docket No. 95626

THE STRONG MANUFACTURING CO., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Appearances: For Taxpayer: Sidney J. Collins, Arthur Morgan, Esq., Raymond S. Powers, Esq. For Commissioner: Stanley B. Pierson, De Witt M. Evans, Esq., Paul A. Sebastian, F. N. Morawaski, Esq.

Docket entries

1938

Sept. 26—Petition received and filed. Taxpayer notified. (Fee paid).

Sept. 26—Copy of petition served on General Counsel.

Nov. 8—Answer filed by General Counsel.

Nov. 8—Request for circuit hearing in Cleveland, Ohio, filed by General Counsel.

Nov. 15—Notice issued placing proceeding on Cleveland, Ohio, Calendar. Answer and request served.

1939

Aug. 31—Hearing set Oct. 23, 1939, Cleveland, Ohio.

Oct. 9—Notice of appearance of Arthur Morgan as counsel for taxpayer filed.

Oct. 9—Notice of appearance of Raymond S. Powers as counsel for taxpayer filed.

Oct. 23—Hearing had before Mr. Opper on merits. Briefs due 12/7/39. Reply Briefs due 12/22/39.

Nov. 4—Transcript of hearing of 10/23/39 filed.

Dec. 7—Brief filed by taxpayer, 12/8/39 copy served on General Counsel.

Dec. 7—Brief filed by General Counsel.

Dec. 20—Reply brief filed by taxpayer.

1940

Feb. 5—Motion for leave to file the attached supplemental memorandum. Memorandum lodged filed by taxpayer. 2/6/40 granted.

May 29—Findings of fact and opinion rendered. Clarence V. Opper, Div. 14. Decision will be entered under Rule 50.

June 21—Computation of deficiency filed by General Counsel.

June 21—Consent to settlement filed by taxpayer.

June 26—Decision entered, C. R. Arundell, Div. 7.

Sept. 14—Petition for review by United States Circuit Court of Appeals, Sixth Circuit, with assignments of error filed by General Counsel.
Sept. 19—Proof of service filed by General Counsel (1).
Sept. 23—Proof of service filed by General Counsel (1).
Oct. 8—Designation of additional portions of record filed by taxpayer, with proof of service thereon.
Oct. 9—Motion for extension of time to Dec. 13, 1940 to complete and transmit the record filed by General Counsel.
Oct. 9—Order enlarging time to Dec. 13, 1940 to prepare and transmit the record, entered.
Oct. 24—Statement of points with proof of service thereon filed by General Counsel.
Oct. 24—Agreed praecipe filed.
Oct. 24—Notice that proceeding has been placed upon the Day Calendar of 11/6/40 for settlement *re* contents of record *sur* petition for review.

3 Nov. 6—Hearing had before Mr. Opper on settlement of contents of record. Ordered that such part of transcript and exhibits as petitioner feels necessary should be included in record on appeal.
Nov. 8—Motion that a transcript of all oral testimony and documentary exhibits offered in evidense herein be included in the record on review of this cause as requested by said respondent in its designation of additional portions of record proceedings and exhibits to be contained in record on review filed Oct. 8, 1940 filed by taxpayer. Granted.
Nov. 19—Transcript of hearing 11/6/40 filed.

Before United States Board of Tax Appeals

Petition

Filed September 26, 1938

The above-named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency (Bureau symbols CLEVELAND IRA-90D-VOD: tm) dated June 30, 1938, and as a basis of its proceedings alleges as follows:

1. The petitioner is an Ohio corporation with its principal office in the Village of Sebring, Ohio.

2. The notice of deficiency (a copy of which is attached and marked Exhibit A) was mailed to the petitioner on June 30, 1938.

3. The deficiency asserted is for the calendar year 1936, as follows:

Income tax	$14,776.89
Excess-profits tax	548.37
Total	$15,325.26

Of this amount, $12,732.10 of income tax and $96.04 of excess-profits tax are in controversy.

4. The determination of tax set forth in the said notice of deficiency is based upon the following errors:

(a) In determining the net income of the petitioner for the year 1936 the Commissioner erroneously disallowed as a deduction $2,215.88 of items charged by petitioner to repair account, less $156.39 of additional depreciation applicable thereto, or a net deduction of $2,059.49 erroneously disallowed.

(b) In determining the amount of undistributed net income of the petitioner subject to surtax the Commissioner erred in disallowing as a credit against such undistributed net income the amount which the petitioner pursuant to the terms of a written contract entered into prior to May 1, 1936, was required to pay or set aside out of the earnings and profits of the taxable year for the payment of mortgage indebtedness.

5. The facts upon which the petitioner relies as the basis of this proceeding are as follows:

(a) Petitioner charged to repair account during the year 1936, $10,383.63 of items which the Examining Officer classified as plant betterments and disallowed as a deduction; many of these items were on the border-line between repairs and improvements, and at a hearing subsequently held at the office of the Internal Revenue Agent in Charge it was agreed between representatives of the Commissioner and of the petitioner that $2,215.88 would be allowed as a deduction, and overallowance of depreciation corrected accordingly.

(b) The agreement referred to in (a) was confirmed by letter of John R. Kirk, Internal Revenue Agent in Charge, under date of February 25, 1938, attached to which were schedules showing the adjustments as agreed, and recomputation of excess-profits and income taxes in accordance therewith.

(c) On April 21, 1932, the petitioner executed a purchase-money mortgage, together with a series of notes secured thereby, to Central United National Bank, Trustee, Cleveland, Ohio; copy of the relevant covenants contained in said notes and mortgage is attached hereto and marked Exhibit B.

(d) Pursuant to its understanding of the terms of the aforesaid notes and mortgage, the petitioner made an approximate

determination of its profits from time to time during 1936, and made principal payments to Central United National Bank, Trustee, during the taxable year, to the amount of $47,000.00, which extinguished the debt.

(e) The total of principal and interest payments to the mortgagee during the year 1936 was less than the forty per centum (40%) of net earnings required to be applied to such payments and therefore the entire sum of $47,000.00 paid on the principal of the debt was claimed as a credit against undistributed net income, in petitioner's income tax return for 1936.

Wherefore, the petitioner prays that this Board may hear the proceeding and determine that the deficiency due from the petitioner for the year 1936 should not be in excess of $2,497.12.

(Signed) SIDNEY J. COLLINS, C. P. A.,
Counsel for Petitioner,
Mahoning Bank Bldg., Youngstown, Ohio.

[*Duly sworn to by W. U. Pfaeffli; jurat omitted in printing.*]

6 EXHIBIT A TO PETITION

[Copy]

CLEVELAND
IRA:90D

JUNE 30, 1938.

STRONG MANUFACTURING COMPANY,
Sebring, Ohio.

GENTLEMEN: You are advised that the determination of your income tax liability for the taxable year ended December 31, 1936 discloses a deficiency of $14.776.89 and that the determination of your excess-profits tax liability for the year mentioned discloses a deficiency of $548.37 as shown in the statement attached.

In accordance with Section 272 (a) of the Revenue Act of 1936, notice is hereby given of the deficiencies mentioned. Within ninety days (not counting Sunday or a legal holiday in the District of Columbia as the ninetieth day) from the date of the mailing of this letter, you may file a petition with the United States Board of Tax Appeals for a redetermination of the deficiencies above stated.

Should you not desire to file a petition, you are requested
7 to execute the enclosed form and forward it to the Internal Revenue Agent in Charge, 415 Hanna Building, Cleveland, Ohio. The signing and filing of this form will expedite the closing of your return by permitting an early assessment of the de-

ficiency and will prevent the accumulation of interest, since the interest period terminates thirty days after filing the form, or on the date assessment is made, whichever is earlier.

Respectfully,

GUY T. HELVERING,
Commissioner,

By (Signed) R. C. CAKE,
Internal Revenue Agent in Charge.

Enclosures:
Statement.
Form 870.

STATEMENT

In re: Strong Manufacturing Company, Sebring, Ohio

STATEMENT OF TOTAL TAX LIABILITY

INCOME TAX LIABILITY

Year ended	Liability	Assessed	Deficiency
Dec. 31, 1936	$39,752.69	$24,975.80	$14,776.89

Excess-profits Tax Liability

Dec. 31, 1936	$2,155.53	$1,607.16	$548.37

In making this determination of your income and excess-profits tax liability, careful consideration has been given to the internal revenue agent's report dated June 9, 1937, a copy of which was mailed to you under date of November 18, 1937; to your protest dated December 16, 1937; and to the statements made at the conferences held on December 29, 1937, February 10, 1938, March 31, 1938 and June 10, 1938.

8 In filing your return for 1936, a credit was claimed in the amount of $47,000.00 in determining undistributed net income, in the computation of surtax on undistributed profits. The credit claimed was based on a contract (mortgage deed and mortgage note) dated April 15, 1932, which you allege restricted the payment of dividends.

It appears that the payments required under the provisions of the mortgage deed and mortgage note are specifically enumerated in the note, and are not, according to the express provisions of the said mortgage deed and mortgage note, required to be made out of the earnings and profits of the taxable year. Accordingly, it is held that the provisions of the contract in this connection do not satisfy the conditions prescribed in Section 26 (c) (2) of the Revenue Act of 1936.

The further requirements of the mortgage deed and mortgage note with respect to the application of 40 per centum of your net earnings for any calendar year, in payment of the interest accruing and becoming payable upon such note in such year, and the balance of the principal amount of such note unpaid prior to April 15th, in such year, which payment was to be made not later than April 15th, of the succeeding year, likewise, do not meet the requirements of Section 26 (c) (2) of the Act for the reason that such contractual provision, although it expressly deals with the earnings and profits of the taxable year, does not require the payment or irrevocable setting aside within the taxable year of such earnings and profits, as specifically provided by the Revenue Act of 1936.

The credit of $47,000.00, has therefore been disallowed.

A copy of the statutory notice of the deficiency, together with a copy of this statement, has been mailed to your representative, Mr. Sidney J. Collins, 711 Mahoning Bank Building, Youngstown, Ohio, in accordance with the authority contained in a power of attorney executed by you and on file in this office.

9 ADJUSTMENTS TO NET INCOME

Year ended Dec. 31, 1936

Net income as disclosed by return		$126,788.04
Unallowable deductions:		
(a) Plant betterments expenses	$10,383.63	
(b) Accrued county taxes	229.86	
		10,613.49
Total		$137,399.53
Additional deductions:		
(c) Depreciation increased	$1,351.08	
(d) Capital stock tax	123.00	
		1,474.08
Net income adjusted		$135,925.45

EXPLANATION OF ADJUSTMENTS

(a) The amount of $10,383.63, expended in the rebuilding and modernizing of your plant and equipment, constitutes a capital expenditure, and is not deductible from gross income. A schedule of the items and amounts involved in the total of $10,383.63 is attached to the revenue agent's report as Exhibit D, a copy of which was furnished you.

(b) Taxes of $5,318.25 claimed as a deduction have been decreased by $229.86, which amount represents the excessive accrual of real estate taxes.

(c) Depreciation of $5,288.31, as claimed has been increased to $6,639.39, resulting in an additional deduction of $1,351.08 as

explained in Exhibit C of the revenue agent's report, a copy of which was furnished you.

(d) Capital stock tax of $1,123.00, for the year ended June 30, 1937, which accrued on July 1, 1936, has been allowed as a deduction in lieu of $1,000.00, as claimed, resulting in a further deduction of $123.00.

10

COMPUTATION OF TAX

Year ended Dec. 31, 1936

EXCESS-PROFITS TAX

Net income for excess-profits tax computation		$135,925.45
Less:		
Dividends received credit	None	
10% of $1,000,000.00, value of capital stock as declared in your capital stock tax return for the year ended June 30, 1936	$100,000.00	
		100,000.00
Net income subject to excess-profits tax		$35,925.45
Excess-profits tax at 6% on $35,925.45 (net income or 5% of declared value of capital stock, whichever is less)		$2,155.53
Excess-profits tax assessed:		
Original Account No. 400301		1,607.16
Deficiency of excess-profits tax		$548.37

INCOME TAX

Normal Tax

Net income for excess-profits tax computation	$135,925.45
Less: Excess-profits tax as computed above	2,155.53
Net income for income tax computation	$133,769.92
Normal tax at 8% on $2,000.00	$160.00
Normal tax at 11% on $13,000.00	1,430.00
Normal tax at 13% on $25,000.00	3,250.00
Normal tax at 15% on $93,769.92	14,065.49
Total normal tax	$18,905.49

SUBTAX OF UNDISTRIBUTED PROFITS

Net income for surtax computation		$133,769.92
Less: Normal tax as computed above		18,905.49
(a) Adjusted net income		$114,864.43
11 Less:		
Dividend paid credit	$10,000.00	
Credit for contract restricting dividend payments	None	
		10,000.00
(b) Undistributed net income		$104,864.43
Less: Specific credit		None
(c) Remainder subject to surtax		$104,864.43

SURTAX ON UNDISTRIBUTED PROFITS—continued

7% of $11,486.44 (portion of (c) not over 10% of (a))	$804.05
12% of $11,486.44 (over 10% and not over 20% of (a))	1,378.37
17% of $22,972.88 (over 20% and not over 40% of (a))	3,905.39
22% of $22,972.88 (over 40% and not over 60% of (a))	5,054.03
27% of $35,945.79 (on excess over 60% of (a))	9,705.36
Total surtax	$20,847.20
Normal tax	18,905.49
Total normal and surtax	$39,752.69
Normal tax and surtax assessed:	
Original, Account No. 400301	24,975.80
Deficiency of income tax	$14,776.89

Exhibit "B" to petition

EXCERPT FROM MORTGAGE NOTE

"As provided in said mortgage deed installments of the principal sum hereof may be anticipated in whole or in part by The Strong Manufacturing Company. In addition The Strong Manufacturing Company shall apply forty per cent (40%) of its net earnings in and for any calendar year beginning January 1, 1934 upon the unpaid balance of said purchase price,
12 provided that the amount so applied shall never be less than the installments of the purchase price specified for payment in such year, all as more fully set forth in said mortgage deed. All payments in excess of the installment required under the terms hereof in any year, whether voluntary or obligatory, shall be applied by the holder hereof against the latest maturing installments of the principal sum hereof."

EXCERPT FROM MORTGAGE DEED

ARTICLE I (1) OF COVENANTS

"The Company covenants and agrees that until the principal and interest of the note secured hereby shall have been fully paid and beginning on January 1st, One thousand nine hundred thirty-four, the Company will apply forty per centum (40%) per annum of its net earnings for any calendar year in payment of the interest accruing and becoming payable upon such note in such year, and the balance of the principal amount of such note unpaid prior to April 15th in such year; provided, however, that the covenent herein made shall not be construed to relieve the Company from the payment on April 15th in such year of the install-

ment specified for payment by the terms of said note nor of the regular interest payments in such year, likewise as specified in said note.

"The term 'net earnings' as herein used means the gross earnings from the business of the Company for such calendar year, less all current expenses of the business, all taxes payable in such year by the Company, and fixed charges other than those created by the note hereby secured.

"Settlement for all amounts becoming due and payable under this provision in excess of the principal and interest payments absolutely required in the calendar year as of which such net earnings are determined shall be made by the Company to the Bank not later than April 15th of the succeeding year."

13 Before United States Board of Tax Appeals

Answer

Filed November 8, 1938

Comes now the Commissioner of Internal Revenue, by his attorney, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, and for answer to the petition of the above-named taxpayer, admits and denies as follows:

1 and 2. Admits the allegations contained in paragraphs 1 and 2 of the petition.

3. Admits that the deficiencies asserted are for the calendar year 1936, and are income tax of $14,776.89 and excess-profits tax of $548.38, total $15,325.26, but denies the remaining allegations contained in paragraph 3 of the petition.

4 (a) and (b). Denies the Commissioner erred in the determination of the deficiencies as alleged in sub-paragraphs (a) and (b) of paragraph 4 of the petition.

5 (a) and (b). Denies the allegations contained in sub-paragraphs (a) and (b) of paragraph 5 of the petition.

5 (c). Admits that on April 21, 1932, the petitioner executed a purchase-money mortgage, together with a series of notes secured thereby, to Central United National Bank, Trustee, Cleveland, Ohio, but denies the remaining allegations contained in sub-paragraph (c) of paragraph 5 of the petition.

5 (d) and (e). Denies the allegations contained in sub-paragraphs (d) and (e) of paragraph 5 of the petition.

6. Denies generally each and every allegation contained in the petition not hereinbefore specifically admitted, qualified, or denied.

Wherefore, it is prayed that the petitioner's appeal be denied and that the Commissioner's determination of deficiency be approved.

(Signed) J. P. WENCHEL,
Chief Counsel,
Bureau of Internal Revenue.

Of Counsel:
DEWITT M. EVANS,
PAUL A. SEBASTIAN,
Special Attorneys,
Bureau of Internal Revenue.

14 Before United States Board of Tax Appeals

Findings of Fact and Opinion

Docket No. 95626. Promulgated May 29, 1940. Contract requiring application of a portion of petitioner's earnings and profits for the taxable year against indebtedness incurred prior to 1936, held, to require irrevocable setting aside of such portion and to entitle petitioner to a credit for purposes of the undistributed profits tax to the extent that such payment was actually made in the taxable year. Revenue Act of 1936, sec. 26 (c) (2).

Arthur Morgan, Esq., Raymond S. Powers, Esq., and Sidney J. Collins, C. P. A., for the petitioner.

DeWitt M. Evans, Esq., Paul A. Sebastian, Esq., and Stanley B. Pierson, Esq., for the respondent.

This proceeding was brought for a redetermination of a deficiency in petitioner's income and excess profits taxes in the amounts of $14,776.89 and $548.37, respectively, for the year 1936.

The issues presented by the pleadings are: (1) Whether petitioner is entitled to a credit under the provisions of section 26 (c) (2) of the Revenue Act of 1936 in computing the surtax on its undistributed profits; and (2) whether petitioner was entitled to certain deductions for expenditures for repairs and replacements.

FINDINGS OF FACT

Petitioner, an Ohio corporation organized in 1932, has its principal offices at Sebring, Ohio, and is engaged in the manufacture of enamelware.

On or about April 15, 1932, petitioner purchased its plant and equipment from the Central United National Bank, Cleveland, Ohio, trustee for the bondholders of the Sebring Manufacturing Corporation. The purchase price was $50,000, for which peti-

tioner on April 15, 1932, executed a note secured by a mortgage to the Central United National Bank (hereinafter referred to as the bank).

15 The note was as follows:

"For value received The Strong Manufacturing Company, a corporation of the State of Ohio, promises to pay to Central United National Bank, of Cleveland, Trustee, or order, Fifty Thousand Dollars ($50,000) in the following installments (all payments to be made at the principal office of said Central United National Bank in the City of Cleveland, Ohio):

$2,000 on April 15, 1934
3,000 on April 15, 1935
5,000 on April 15, 1936
6,000 on April 15, 1937
7,000 on April 15, 1938
8,000 on April 15, 1939
9,000 on April 15, 1940
10,000 on April 15, 1941

"Any unpaid portion of the said principal sum shall bear interest from April 15, 1932 at the rate of six per centum (6%) per annum until paid; such interest shall be paid semi-annually at said office of Central United National Bank on the 15th day of October and April in each year.

"This note is issued pursuant to, and payment of the principal thereof and of the interest thereon is secured by a certain first mortgage deed dated as of April 15, 1932, duly made, executed and delivered by The Strong Manufacturing Company to Central United National Bank of Cleveland, Trustee, to which mortgage deed reference is hereby made to the same effect as if herein set forth for a statement of the properties and rights mortgaged and pledged and the nature and extent of the rights of the holder hereof.

"As provided in said mortgage deed installments of the principal sum hereof may be anticipated in whole or in part by The Strong Manufacturing Company. In addition The

16 Strong Manufacturing Company shall apply forty per cent (40%) of its net earnings in and for any calendar year beginning January 1, 1934 upon the unpaid balance of said purchase price, provided that the amount so applied shall never be less than the installment of the purchase price specified for payment in such year, all as more fully set forth in said mortgage deed. All payments in excess of the installment required under the terms hereof in any year, whether voluntary or obliga-

tory, shall be applied by the holder hereof against the latest maturing installments of the principal sum hereof."

On the same date petitioner executed the mortgage securing the note. Its pertinent provisions are as follows:

"ARTICLE I

"Anticipation of Payments upon Note

"(1) The Company covenants and agrees that until the principal and interest of the note hereby secured shall have been fully paid and beginning on January 1st, One Thousand nine hundred thirty four, the Company will apply forty per centum (40%) per annum of its net earnings for any calendar year in payment of the interest accruing and becoming payable upon such note in such year, and the balance of the principal amount of such note unpaid prior to April 15th in such year; provided, however, that the covenant herein made shall not be construed to relieve the Company from the payment on April 15th in such year of the installment specified for payment by the terms of said note nor of the regular interest payments in such year, likewise as specified in said note. The term "net earnings" as herein used means the gross earnings from the business of the Company for such calendar year, less all current expenses of the business, all taxes payable in such year by the Company and fixed charges other than those created by the note hereby secured.

17 Settlement for all amounts becoming payable under this provision in excess of the principal and interest payments absolutely required in the calendar year as of which such net earnings are determined shall be made by the Company to the Bank not later than April 15th of the succeeding year.

(2) The Company covenants and agrees that so long as the principal and interest hereby secured remain unpaid, it will furnish to the Bank quarterly statements of the financial condition and operations of the Company, and in addition, shall on or before April 15th in each year furnish to the Bank a detailed balance sheet as of the close of the preceding calendar year, audited by public accountants acceptable to the Bank. The Company shall also furnish to the Bank, at any time that it may so demand in writing, such information as may, in the Bank's judgment, be necessary and proper to give it sufficient ground for the taking or not taking of any action required or permitted hereunder, and shall permit the Bank or its agents, upon like demand, at any time, to examine its premises, property, records and books of account, and the Company shall and will do everything in its power to facilitate such examination.

(3) The Company may, at its option, at any time so long as it is not in default under any of the provisions hereof, anticipate any part of the principal amount secured hereby. Any sums paid by the Company in excess of the principal and interest payments fixed by the terms of the note hereby secured, whether made voluntarily under the provisions of this paragraph or under the provisions of paragraph (1) of this Article I, shall be applied by the Bank in payment of the latest maturing installments specified in said note.

* * * * * *

18 "ARTICLE IV

"Remedies on Default

"(1) If the Company shall make default in the payment of any interest or principal specified in the note hereby secured, and any such default shall have continued for thirty (30) days; or shall default in the performance of its covenants contained in Article I, Paragraph 1 hereof, and such default shall have continued for thirty (30) days; * * * the Bank may declare the entire principal then unpaid immediately due and payable, and the same and the interest accrued thereon shall thereupon become and be immediately due and payable, anything in said bonds or herein contained to the contrary notwithstanding. * * *

"(2) No waiver by the Bank of any such default by the Company, whether such waiver be full or partial, shall extend to or be taken to affect any subsequent default or to impair the rights resulting therefrom."

* * * * * *

The provision of article I, paragraph 1, above quoted, with reference to petitioner's obligation to apply 40 percent of the earnings of each year on the note and mortgage, was required by the bank in order that in prosperous years petitioner would devote a portion of its profits to the payment of the mortgage, and the bank would be protected to this extent should the company later become involved in difficulties.

On May 28, 1934, petitioner and the bank executed an agreement wherein it was recited that the company was not able to pay the principal installment of $2,000 due April 15, 1934, and was in default in payment of the interest in the approximate amount of $3,500. By the agreement the bank granted an extension to April 15, 1941, for the payment of the principal installment and an extension to April 15, 1935, for $3,000 of the delinquent
19 interest. The extension on the principal payment was "with the understanding, however, that such extension shall not be construed as a waiver of any subsequent defaults."

There was no modification of the provision requiring petitioner to apply 40 percent of its net earnings in payment of the principal and interest.

Petitioner's income and excess profits tax return for the year 1936 reported a net income of $126,786.04.

On January 1, 1936, petitioner owed $47,000 on its indebtedness on the note and mortgage. During the year 1936 it made payments on the principal sum on the dates and in the amounts as follows:

2/15/36	$2,500	6/29/36	$1,000	9/15/36	$5,00
4/15/36	2,500	7/14/36	500	10/15/36	34,000
5/15/36	500	7/31/36	1,000		
5/29/36	1,000	8/14/36	500	Total	46,500
6/15/36	500	8/31/36	2,000		

The bank accepted the $46,500 payment in 1936 in full satisfaction of the $47,000 due, and also forgave $117.50 interest.

By September 30, 1936, petitioner's approximate profits were $86,000, and it had orders on its books in that month of approximately $100,000. Since it appeared that petitioner's profits would be such that 40 percent thereof would be in excess of the amount required to discharge the mortgage in full, it was decided to make the payment at that time. It would not have been possible to determine on January 1, 1937, the profits of petitioner for 1936 with complete accuracy.

The parties have stipulated, and we accordingly find, that petitioner should be allowed deduction of $2,215.88 as expenses for repairs and replacements during the taxable year.

Opinion

OPPER: The present issue calls for the application to the foregoing facts of the provisions of section 26 (c) (2) of Revenue Act of 1936 [1] entitling a corporation to a "credit" against the "undistributed profits tax" if it complies with certain requirements.

[1] SEC. 26. CREDITS OF CORPORATIONS.

In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

* * * * * * * * *

(c) CONTRACTS RESTRICTING PAYMENT OF DIVIDENDS.—

* * * * * * * * *

(2) DISPOSITION OF PROFITS OF TAXABLE YEAR.—An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been so paid or set aside. For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits. as used in this paragraph, the word "debt" does not include a debt incurred after April 30, 1936.

On this record, compliance with these conditions is questionable only in one respect. There was a written contract executed prior to May 1, 1936, containing a provision expressly dealing with the disposition of earnings and profits for the taxable year. The credit claimed is for an amount equal to the portion of such earnings and profits required to be paid in discharge of a debt, and this amount was paid in the taxable year. The sole remaining condition is that such portion of the earnings and profits be required by the contract to be paid or irrevocably set aside within the taxable year. We are of the opinion that the "application" to the indebtedness of the designated portion of the earnings may, for present purposes, be considered to be called for by the contract "as of" the taxable year, *Michigan Silica Co.*, 41 B. T. A. 511, 515, and, therefore, to constitute the irrevocable setting aside contemplated by the statute. The credit should have been allowed and respondent's determination to the contrary is overruled.

Repair and replacement expenses may be deducted as stipulated.

Reviewed by the Board. Decision will be entered under Rule 50.

21 BLACK, dissenting: I can readily agree that from the standpoint of reason and logic there would seem just as good reason for Congress to grant a credit in determining surtax on undistributed profits to a corporation situated as was the petitioner in the instant case as there was to other corporations which had contracts of indebtedness which come more precisely within the terms of the statute (sec. 26 (c) (2), 1936 Act). But it is the precise statute which we have to construe and I do not see how it can be so broadly construed as to admit a credit to petitioner under the facts as they have been found.

The statute in question, which has been set out in the majority opinion, seems to provide four things as conditions precedent to securing the credit. These are:

(1) There must exist a written contract executed by the corporation prior to May 1, 1936. Here there was a written contract executed prior to May 1, 1936, and so that condition is fulfilled.

(2) This contract must deal with the earnings and profits of the taxable year. The contract in question does deal with 40 percent of the net earnings of petitioner for the taxable year, so that condition is met.

(3) The contract must require the payment or the irrevocable setting aside of the earnings in question during the taxable year for the discharge of the debt in question. In the instant case

it is plain that the contract does not require that the 40 percent of the net earnings be paid on the indebtedness during the taxable year. On the contrary, petitioner was granted until April 15 of the following year in which to make payment. So it seems clear to me that, in so far as payment is concerned, the contract in question does not meet the terms of the statute. But the statute grants the credit if there is a requirement in the contract that the portion of earnings in question be "irrevocably set aside" during the taxable year for the discharge of the debt. I see nothing in the contract which required the taxpayer to irrevocably set aside any of its earnings of 1936 prior to the granted time of payment which was April 15, 1937. So, in the
22 view I take, one of the conditions precedent is not met.

I can not take the view expressed in the majority opinion that when the statute says that the contract must require either payment or irrevocable setting aside of earnings within the taxable year it means "as of" the taxable year. I see no warrant for such construction.

(4) The credit granted, when all conditions have been fulfilled, is the amount which "has been so paid or set aside." In the instant case there has been a payment all right on the indebtedness to the full extent of the credit claimed, but, as I view it, in the absence of a requirement in the contract that these earnings be paid or irrevocably set aside in 1936, their actual payment in 1936 becomes immaterial.

Congress in the Revenue Act of 1938 wrote a provision which seems to be broad enough to permit a credit under the facts and circumstances of the instant case. See sec. 27 (a) (4), Revenue Act of 1938. This section, however, has no retroactive application and, for reasons which I have already stated, I do not believe that the credit which petitioner claims can be granted under the terms of the 1936 Act. I think the Commissioner should be sustained and I, therefore, respectfully dissent from the majority opinion.

MELLOTT and KERN agree with this dissent.

23 Before United States Board of Tax Appeals

Decision

Entered June 26, 1940

Pursuant to the Findings of Fact and Opinion of the Board promulgated May 29, 1940, the respondent herein on June 21, 1940, having filed a recomputation of tax and the petitioner on

June 21, 1940, having filed an acquiescence therein, now, therefore, it is

Ordered and Decided: That there are deficiencies in this petitioner's income and excess-profits taxes for the year 1936 in the respective amounts of $2,133.63 and $420.40.

(Signed) C. R. ARUNDELL, *Member.*

Enter:

In United States Circuit Court of Appeals

Petition for Review and Assignments of error

Filed September 14, 1940

To the Honorable Judges of the United States Circuit Court of Appeals for the Sixth Circuit:

Now comes the Commissioner of Internal Revenue, by his attorneys, Samuel O. Clark, Jr., Assistant Attorney General, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, and John M. Morawski, Special Attorney, Bureau of Internal Revenue, and respectfully shows:

I

JURISDICTION

The petitioner on review is the duly appointed, qualified and acting Commissioner of Internal Revenue, hereinafter referred to as the Commissioner, holding his office by virtue of the laws of the United States.

24 The respondent on review, The Strong Manufacturing Company, (hereinafter referred to as the taxpayer), is a corporation organized and existing under the laws of the State of Ohio, with its principal office in the Village of Sebring, Ohio. The Strong Manufacturing Company filed its income and excess-profits tax return for the calendar year 1936 with the Collector of Internal Revenue for the 18th District of Ohio, at Cleveland, Ohio, and within the judicial circuit of the United States Circuit Court of Appeals for the Sixth Circuit.

II

Prior Proceedings

On June 30, 1938, the Commissioner determined deficiencies in income and excess-profits taxes for the year 1936 in the respective amounts of $14,776.89 and $548.37, and sent to the taxpayer by registered mail a notice of said deficiencies in accordance

with Section 272 (a) of the Revenue Act of 1936. Thereafter, and on September 26, 1938, the taxpayer filed a petition for a redetermination of said deficiencies by the United States Board of Tax Appeals.

The case was tried before the Board of Tax Appeals on October 23, 1939, at Cleveland, Ohio.

On May 29, 1940, the Board promulgated its findings of fact and opinion (41 B. T. A. —, No. 174), and on June 26, 1940 entered its decision that there are deficiencies in income and excess-profits taxes for the year 1936 in the respective amounts of $2,133.63 and $420.40.

III

Nature of Controversy

The issue decided against the Commissioner relates to the credit claimed by the taxpayer, under Section 26 (c) (2) of the Revenue Act of 1936, in computing its liability for surtax on undistributed profits. On January 1, 1936, taxpayer owed $47,000 on its indebtedness on a note and mortgage. During the year 1936, under Section (1) of Article I of the mortgage, taxpayer made payments on the principal sum in the aggregate amount of $46,500.

Said Section (1) of Article I reads as follows:

"ARTICLE I

"Anticipation of Payments Upon Note

"(1) The Company covenants and agrees that until the principal and interest of the note hereby secured shall have been fully paid and beginning on January 1st, One Thousand nine hundred thirty four, the Company will apply forty per centum (40%) per annum of its net earnings for any calendar year in payment of the interest accruing and becoming payable upon such note in such year, and the balance of the principal amount of such note unpaid prior to April 15th in such year; provided, however, that the covenant herein made shall not be construed to relieve the Company from the payment on April 15th in such year of the installment specified for payment by the terms of said note nor of the regular interest payments in such year, likewise as specified in said note. The term 'net earnings' as herein used means the gross earnings from the business of the Company for such calendar year, less all current expenses of the business, all taxes payable in such year by the Company and fixed charges other than those created by the note hereby secured.

"Settlement for all amounts becoming payable under this provision in excess of the principal and interest payments absolutely

required in the calendar year as of which such net earnings are determined shall be made by the Company to the Bank not later than April 15th of the succeeding year."

The Commissioner, in his notice of deficiency, refused to allow any credit claimed for contracts restricting dividend payments, on the ground that the amount in question was not required by the contract to be paid or irrevocably set aside, within the taxable year as provided by Section 26 (c) (2) of the statute. The
26 taxpayer claimed a credit of $16,500. The Board of Tax Appeals, however, sustained the taxpayer.

IV

Assignments of Error

The Commissioner avers that in the record and proceedings before the United States Board of Tax Appeals and in the opinion and final decision rendered and entered by the United States Board of Tax Appeals, manifest error occurred and intervened to the prejudice of the Commissioner who now assigns the following errors and each of them, which he avers occurred in said record, proceedings, opinion and final decision so rendered and entered by the United States Board of Tax Appeals.

1. The Board erred in holding and deciding that there is a deficiency in income tax for the year 1936 in the amount of only $2,133.63.

2. The Board erred in failing to sustain the deficiency in income tax determined by the Commissioner for the year 1936 in the amount of $14,776.89 less the proper reduction of said amount to reflect the adjustments agreed upon by the parties at the hearing before the Board of Tax Appeals.

3. The Board erred in holding that "we are of the opinion that the 'application' to the indebtedness of the designated portion of the earnings may, for present purposes, be considered to be called for by the contract 'as of' the taxable year, Michigan Silica Co., 41 B. T. A. 511, 515, and, therefore, to constitute the irrevocable setting aside contemplated by the statute."

4. The Board erred in holding that the credit should have been allowed and that the Commissioner's determination to the contrary is overruled.

5. The Board erred in that its opinion and decision are not supported by the evidence and are contrary to law.

Wherefore, the Commissioner petitions that the decision of the Board of Tax Appeals be reviewed by the United States
27 Circuit Court of Appeals for the Sixth Circuit, that a transcript of the record be prepared in accordance with

law and with the rules of said Court and transmitted to the Clerk of said Court for filing, and that appropriate action be taken to the end that the errors complained of may be reviewed by said Court.

(Sgd.) SAMUEL O. CLARK, JR.,
Assistant Attorney General,
(Signed) J. P. WENCHEL,
CAR
Chief Counsel;
Bureau of Internal Revenue.

Of Counsel:
JOHN M. MORAWSKI,
Special Attorney,
Bureau of Internal Revenue.

[*Duly sworn to by John M. Morawski; jurat omitted in printing.*]

28 In United States Circuit Court of Appeals

Notice of filing petition for review.

Filed September 19, 1940

To: ARTHUR MORGAN, Esq., and
RAYMOND S. POWERS, Esq.,
704 Union National Bank Building,
Youngstown, Ohio.

You are hereby notified that the Commissioner of Internal Revenue did, on the 14th day of September, 1940, file with the Clerk of the United States Board of Tax Appeals, at Washington, D. C., a petition for review by the United States Circuit Court of Appeals for the Sixth Circuit, of the decision of the Board heretofore rendered in the above-entitled cause. A copy of the petition for review and the assignments of error as filed is hereto attached and served upon you.

Dated this 14th day of September, 1940.

(s) B. D. GAMBLE, *Clerk,*
U. S. Board of Tax Appeals.

Service of the above and foregoing notice, together with a copy of the petition for review and assignments of error mentioned therein, is hereby acknowledged this 17th day of September 1940.

(s) ARTHUR MORGAN,
(s) RAYMOND S. POWERS,
Attorneys for Respondent on Review.

29 In United States Circuit Court of Appeals

Notice of filing petition for review

Filed September 23, 1940

To: THE STRONG MANUFACTURING COMPANY,
Sebring, Ohio.

You are hereby notified that the Commissioner of Internal Revenue did, on the 14th day of September 1940, file with the Clerk of the United States Board of Tax Appeals, at Washington, D. C., a petition for review by the United States Circuit Court of Appeals for the Sixth Circuit, of the decision of the Board heretofore rendered in the above-entitled cause. A copy of the petition for review and the assignments of error as filed is hereto attached and served upon you.

Dated this 14th day of September 1940.

(Signed) J. P. WENCHEL,
CAR
Chief Counsel,
Bureau of Internal Revenue.

Personal service of the above and foregoing notice, together with a copy of the petition for review and assignments of error mentioned therein, is hereby acknowledged this 17th day of September 1940.

(s) T. F. SHAFFER, *Secy.-Treas.,*
Respondent on Review.

30 Before United States Board of Tax Appeals

Designation by respondent on review of additional portions of record, proceedings, and evidence to be contained in record on review

Filed October 8, 1940

To the Clerk of the United States Board of Tax Appeals:

You will please prepare, transmit and deliver to the Clerk of the United States Circuit Court of Appeals for the Sixth Circuit, copies duly certified as correct of the following additional documents and records in the above-entitled cause, in connection with the petition for review by the said Circuit Court of Appeals for the Sixth Circuit, heretofore filed by the Commissioner of Internal Revenue:

(1) Transcript of all oral testimony and documentary exhibits offered in evidence herein.

(s) ARTHUR MORGAN,
(s) RAYMOND S. POWERS,
Counsel for Respondent on Review.

Service of a copy of the within designation of additional portions of record, proceedings, and evidence to be contained in the record on review is hereby admitted this 4th day of October 1940.

(s) J. P. WENCHEL,
Chief Counsel,
Bureau of Internal Revenue.

31 Before United States Board of Tax Appeals

Statement of evidence

Filed November 4, 1939

Hearing at Cleveland, Ohio, on the 23rd day of October, 1939, at 2:30 o'clock P. M.

The above entitled proceeding came on for hearing on this the 23rd day of October, 1939, before the Honorable CLARENCE V. OPPER, Member of the United States Board of Tax Appeals, at Cleveland, Ohio, pursuant to notice of hearing heretofore given; whereupon, the following proceedings were had and testimony heard, to-wit:

Appearances: Raymond S. Powers, Esq., Union National Bank Building, Youngstown, Ohio, appearing on behalf of the Petitioner. Stanley B. Pierson, Esq., (Honorable J. P. Wenchel, Chief Counsel) appearing on behalf of Bureau of Internal Revenue, Commissioner of Internal Revenue, Respondent.

32 SIDNEY J. COLLINS, called as a witness by and on behalf of the petitioner, having been first duly sworn, was examined and testified as follows:

The CLERK. State your name, please.

The WITNESS. Sidney J. Collins.

Direct examination by Mr. POWERS:

Q. You are a certified public accountant, are you?

A. Yes.

Q. You are member of what firm of accountants?

A. Clark & Collins, Certified Public Accountants.

Q. Where do you live, Mr. Collins?

A. Youngstown, Ohio.

Q. Does your firm have offices otherwise than in Youngstown?
A. Yes.
Q. What cities?
A. Cleveland, Canton, Warren, and Youngstown.
Q. You are the State Board of Accountancy, are you?
A. Ohio State Board.
Q. For how long have you been a member of that board?
A. Ten years.
Q. Mr. Collins, you have been doing accounting work for the Strong Manufacturing Company?
A. Yes.
Q. Will you state what the profits of the Strong Manufacturing Company were in the year 1936?
53 A. With reference to the income tax return prepared by our office, the profits were $126,786.04.
Q. And that is modified, of course, by the stipulation in this case in regard to——
A. Under the stipulation agreed to by Petitioner and Respondent, the amount of $8,000.00, the exact amount I do not have, would be reflected in the profits by increasing them for that year in that amount.
Q. You prepared that income tax report, Mr. Collins, did you?
A. It was prepared under my supervision.
Q. Calling your attention to Exhibits 2 and 3 of Petitioner, are you familiar with their contents?
A. I am.
Q. And when it came to the end of the year, 1936, what did you do in relation to these contracts as effecting the setting aside of funds for any particular purpose? What did you consider your duties and obligations were as accountant of the Strong Manufacturing Company?
Mr. PIERSON. Just a moment, Your Honor. I object to that. I believe that this witness can probably state what he did, but as to his duties and obligations, I object to that part of the question.
Mr. POWERS. I withdraw the question and will reframe it, with your permission.

By Mr. POWERS:

Q. What did you do, Mr. Collins, at any time during the year 1936 in regard to this contract and to the accounts of the Strong Manufacturing Company?
A. As a certified public accountant, it becomes part of our duties to be familiar with income tax laws, so that we might prepare these tax returns in accordance with those laws and

regulations. The undistributed income tax feature, of course, was studied a great deal, and in this case the instruments requiring the payment of forty per cent of net earnings was considered as a deduction, as a contract under Section 26C–2 so that this amount, $47,000.00, was so deducted in the preparation
54 of the Strong Manufacturing Company's tax return for the year 1936.

Q. Was there any conference prior to the payment of these sums or any part of these sums by the Strong Manufacturing Company to the Central United National Bank on which your advice was asked?

A. Yes. In September of 1936 the President and Treasurer of the company and their counsel, Mr. Morgan, invited us to a conference on the question of the payment of the mortgage and its requirement under this contract. There were several discussions with other attorneys on the point, and the Treasurer showed the profits to September 30th, which we checked on the books, and they also—that is, the Treasurer submitted evidence of future earnings for the balance of that year. Insofar as it is possible, we determined this, reported to the company officials our estimate that profits would be in excess of forty per cent. That, of course, would be subject to something that might happen during the year after September 30th. However, it was our recommendation that since the profits were to be such that forty per cent, being in excess of the requirements of this contract, if they were able financially to do so, that they would pay during the year on the contract. Does that answer your question?

Q. Would it have been possible to determine the exact earnings of the Strong Manufacturing Company as of December 31, 1936, for the preceding taxable year on January 1st? I mean, would it have been physically possible?

A. No. The whole structure of accounting is based at the close of the year, December 31st, at midnight. The books must yet be closed, inventories must be checked. Proper recognition of that is given by the income tax requirement that tax return be filed two and a half months following the close of the year. So it is actually impossible to determine the exact profits in the calendar year as of December 31st in that year.

Q. And this applies to the Strong Manufacturing Company?

55 A. Yes. And in the study of the law under 26C–2 we had to——

Mr. PIERSON. Now, if your Honor please——

A. We had—I am going to state what we told the company.

Mr. PIERSON. All right.

A. We instructed or notified this company that the construction of that law was our opinion—rather, our opinion was that the construction of 26C–2 was that they must pay or irrevocably set aside forty percent of the profits in the year 1936. We did explain to them, upon their request, as to this payment, it would be physically impossible for them to be sure of profits until after the books were closed. We, therefore, put our own construction on this contract that the law, including irrevocably setting aside, was taking care of that contingency where the company was not sure as of December 31st that the profits would be sufficient to require the payment of forty percent.

Q. In your experience, are there any companies who could have determined their profits within the taxable year, accurately?

Mr. PIERSON. Just a moment. I object to that, Your Honor. I think it is immaterial, irrelevant.

Mr. POWERS. As I understand it, that is the issue in this case. It is because the provision of the contract permitted the payment of the money, the actual physical transfer of the money on or before April 15th of the succeeding year; that it is contended by counsel for the Commissioner of the Internal Revenue Department that because the money is not paid over or required to be paid over before the end of the taxable year, that, therefore, the contract does not come within the 26C–2, and it is our purpose to demonstrate that this is an utterly impractical construction of 26C–2, and makes it utterly impossible of performance.

The MEMBER. I will overrule the objection and allow this witness to answer for what it is worth. The experience of one accountant as to the offices he has had contact with, raises a serious doubt in my mind whether it is worth anything, but I will overrule the objection.

56.

By Mr. POWERS:

Q. First, Mr. Collins, I will ask you how long have you been in the accounting business?

A. Since I came back from France; 1919.

Q. Over that period of time, what has been your experience?

A. I have served as an instructor in accountancy in the university, been actively engaged in accounting since 1921 in public practice. During that time I have appeared before the Board of Tax Appeals on income tax many times.

Q. How many companies have you prepared income tax returns for?

A. It would be rather difficult, Mr. Powers, but we have some two hundred active clients at the present time.

Q. Are they conducting one type of business, or are they diversified?

A. All kinds.

Q. Would you consider they represent a cross section of industrial activity in this vicinity?

A. I do.

Q. I will ask you, Mr. Collins, if any of those corporations could accurately determine their profits on December 31st of the year in which those profits are earned?

A. It would be physically impossible to determine the actual profits of the calendar year as of the last day.

Q. Of any of the corporations you represent?

A. Any corporations, with one exception of the bank, which, as of the close of the next day, there is a trial balance which does show the profits as of that year.

Q. How about industria corporations?

A. Industrial corporat. ns, no. I might add, any corporation that has a physical inventory on which it bases
57 its profits, could not take that inventory until the close of the year. If they did, they would be subject to penalty from the income tax department for not having the correct inventories.

Q. And therefore, if a contract or a mortgage obligation provided for the application of a certain percentage of profits payable in the year in which the profits were earned, it would be impossible for a corporation to comply with those conditions?

Mr. PIERSON. I object to that, Your Honor.

A. Absolutely.

Mr. PIERSON. Just a moment. I object to that, Your Honor.

The MEMBER. I will take it for what it is worth. Overrule the objection.

Mr. PIERSON. No questions.

Witness excused.

85 *Petitioner's Exhibit 2*

October 15, 1936. Paid.

CENTRAL NATIONAL BANK OF CLEVELAND,

(Signed) ANTHONY POSS,

Authorized Officer.

(S. B. Pierson)

CLEVELAND, OHIO, *April 15, 1932.*

For value received The Strong Manufacturing Company, a corporation of the State of Ohio, promises to pay to Central United National Bank, of Cleveland, Trustee, or order, Fifty Thousand Dollars ($50,000) in the following installments (all

payments to be made at the principal office of said Central United National Bank in the City of Cleveland, Ohio):

$2,000 on April 15, 1934
3,000 on April 15, 1935
5,000 on April 15, 1936
6,000 on April 15, 1937
7,000 on April 15, 1938
8,000 on April 15, 1939
9,000 on April 15, 1940
10,000 on April 15, 1941

Any unpaid portion of the said principal sum shall bear interest from April 15, 1932, at the rate of six per centum (6%) per annum until paid; such interest shall be paid semi-annually at said office of Central United National Bank on the 15th day of October and April in each year.

This note is issued pursuant to, and payment of the principal thereof and of the interest thereon is secured by a certain first mortgage deed dated as of April 15, 1932, duly made, executed and delivered by The Strong Manufacturing Company to Central United National Bank of Cleveland, Trustee, to which mortgage deed reference is hereby made to the same effect as if herein set forth for a statement of the properties and rights mortgaged and pledged and the nature and extent of the rights of the holder hereof.

86 As provided in said mortgage deed installments of the principal sum hereof may be anticipated in whole or in part by The Strong Manufacturing Company. In addition The Strong Manufacturing Company shall apply forty per cent. (40%) of its net earnings in and for any calendar year beginning January 1, 1934, upon the unpaid balance of said purchase price, provided that the amount so applied shall never be less than the installment of the purchase price specified for payment in such year, all as more fully set forth in said mortgage deed. All payments in excess of the installment required under the terms hereof in any year, whether voluntary or obligatory, shall be applied by the holder hereof against the latest maturing installments of the principal sum hereof.

THE STRONG MANUFACTURING COMPANY,
(Signed) By W. U. PFAEFFLI,
President.

Attest:

(Signed) T. F. SHAFFER,
Secretary.

Petitioner's Exhibit 3

(S. B. Pierson)

OCTOBER 15, 1936.

The conditions of the within mortgage have been complied with and the same is hereby satisfied and discharged.

CENTRAL NATIONAL BANK OF CLEVELAND
(Successor by change of name to Central United B).

This Indenture of Mortgage, made as of the 15th day of April, One Thousand nine hundred and thirty-two, by and between The Strong Manufacturing Company (hereinafter sometimes called the "Company"), a corporation organized and existing
87 under and by virtue of the laws of the State of Ohio and having a legal residence and principal office and place of business in the Village of Sebring, County of Mahoning and State of Ohio, party of the first part, and Central United National Bank of Cleveland (hereinafter sometimes called the "Bank"), a corporation organized and existing under and by virtue of the laws of the United States of America, and having a legal residence and principal office and place of business in the City of Cleveland, County of Cuyahoga and State of Ohio, party of the second part.

Whereas, the Bank has heretofore acquired title to the property hereinafter more particularly described in trust for the holders of certain bonds outstanding as of December 22, 1931, which bonds were issued under a certain Indenture of First Mortgage dated September 15, One thousand nine hundred and twenty-five and executed by Sebring Manufacturing Corporation; and

Whereas, the Bank has by action of more than a majority of said bondholders been authorized to sell and transfer such property to the Company for and upon the consideration of the payment to the Bank as Trustee by the Company of Fifty Thousand Dollars ($50,000.00) and other good and valuable considérations, such Fifty Thousand Dollars ($50,000.00) to be payable in installments beginning April 15th, One thousand nine hundred and thirty-four, as represented by the promissory note of the Company in the following tenor and form, to-wit:

CLEVELAND, OHIO, *April 15, 1932.*

"For value received The Strong Manufacturing Company, a corporation of the State of Ohio, promises to pay to Central United National Bank, of Cleveland, Trustee, or order, Fifty Thousand Dollars ($50,000) in the following installments (all payments to be made at the principal office of said Central United National Bank in the City of Cleveland, Ohio):

88 $2,000 on April 15, 1934
3,000 on April 15, 1935
5,000 on April 15, 1936
6,000 on April 15, 1937
7,000 on April 15, 1938
8,000 on April 15, 1939
9,000 on April 15, 1940
10,000 on April 15, 1941.

"Any unpaid portion of the said principal sum shall bear interest from April 15, 1932 at the rate of six per centum (6%) per annum until paid; such interest shall be paid semi-annually at said office of Central United National Bank on the 15th day of October and April in each year.

"This note is issued pursuant to, and payment of the principal thereof and of the interest thereon is secured by a certain first mortgage deed dated as of April 15, 1932, duly made, executed and delivered by The Strong Manufacturing Company to Central United National Bank of Cleveland, Trustee, to which mortgage deed reference is hereby made to the same effect as if herein set forth for a statement of the properties and rights mortgaged and pledged and the nature and extent of the rights of the holder hereof.

"As provided in said mortgage deed installments of the principal sum hereof may be anticipated in whole or in part by The Strong Manufacturing Company. In addition The Strong Manufacturing Company shall apply forty per cent. (40%) of its net earnings in and for any calendar year beginning January 1, 1934 upon the unpaid balance of said purchase price, provided that the amount so applied shall never be less than the installment of the purchase price specified for payment in such year, all as more fully set forth in said mortgage deed. All payments in excess of the installment required under the terms hereof in any year, whether voluntary or obligatory, shall be applied by
89 the holder hereof against the latest maturing installments of the principal sum hereof.

"THE STRONG MANUFACTURING COMPANY,

"By: ----------

"President.

"Attest: ----------

"Secretary."

Whereas, said note is to be secured by a mortgage in the form hereof upon the said properties hereinafter described, which note and mortgage the Company has full power under its charter and under the laws of the State of Ohio to make;

NOW, THEREFORE, THIS INDENTURE WITNESSETH:

That for and in consideration of the premises and of the sum of One Dollar to it in hand paid by the Bank, receipt whereof is hereby acknowledged, and in order to secure the due and punctual payment of the principal and interest of the note hereby secured according to its tenor and of the covenants, promises and agreements in said note and herein contained, The Strong Manufacturing Company, party of the first part hereunder, does hereby give, grant, bargain, sell, convey, assign, transfer and set over unto Central United National Bank of Cleveland, its successors and assigns;

FIRST. All the following described real estate, lands and premises, situated in the Village of Sebring, County of Mahoning and State of Ohio,

"And known as being village lots Nos. 962 to 997 inclusive, according to the latest enumeration of lots in said Village, together with that part of outlot No. 33 which was formerly an alley and which was vacated by ordinance No. 141, and also that part of outlot No. 34 which was formerly part of Tennessee Avenue and which was vacated by ordinance No. 141, said lots forming a parcel of land having a frontage of 500 feet on the southerly side of California Avenue in said Village and
90 extending southerly therefrom along the westerly line of 18th Street, a distance of 453.2 feet to a fifteen foot alley; thence westerly along the northerly line of said fifteen foot alley a distance of 500 feet to the easterly line of 19th Street; thence northerly along the easterly line of 19th Street a distance of 464 feet to the southerly line of California Avenue.

"Subject to the rights or easements for the maintenance of two side tracks upon and over two strips of the above described property 15 feet in width, heretofore granted by The Strong Manufacturing Company to the Pennsylvania Company by deed dated October 18, 1913 and recorded in Vol. 188, Page 225 of Mahoning County Records.

"Together with all and singular the rights, privileges, hereditaments and appurtenances now or hereafter belonging or in anywise appertaining to the said above described premises."

SECOND. All offices, shops, factories, furnaces, warehouses, barns, buildings, structures and improvements now on said hereby conveyed premises or that may hereafter be erected or placed thereon.

THIRD. The manufacturing plant now owned by the Bank and located upon the land hereinabove described, together with any hereafter made improvements thereof and additions thereto, in-

cluding all railroad and railway tracks, industrial tracks, side tracks and sidings, elevators, conveyors, pipes and fittings, sprinkler system, heating system, machinery, shafting, belting, engines, boilers, kilns, furnaces, motors, electrical appliances, benches, boxes, trucks, scales, auto trucks, tools, implements, utensils, laboratory equipment, spare parts relating to plant equipment, trade and office fixtures and furniture, dies, drawings, patterns, and all other apparatus, appliances and equipment of every description now owned or that may hereafter be acquired or received by the Company.

FOURTH. Also, any and all property which may from
91 time to time hereafter by delivery or by writing of any kind be conveyed, assigned or transferred to the Bank by the Company or by any person or corporation to hold as part of the property herein mortgaged.

Provided, however, that nothing in this Indenture contained shall be deemed to apply to or cover the following property of the Company; cash on hand or in bank; securities, stocks, bonds, bills or notes and accounts receivable, trade acceptances receivable, advances to and accounts with agents and employees, advanced deposits in the usual course of business for water, gas and insurance, checks, raw material, material in process of manufacture or manufactured material and inventory, nor any other property ordinarily included under the term current assets.

To have and to hold the above described and hereby granted lands, premises, property, obligations, rights and assets unto the said Bank, its successors and assigns, upon the terms, covenants and conditions hereinafter set forth:

ARTICLE I

ANTICIPATION OF PAYMENTS UPON NOTE

(1) The Company covenants and agrees that until the principal and interest of the note hereby secured shall have been fully paid and beginning on January 1st, One Thousand nine hundred thirty-four, the Company will apply forty per centum (40%) per annum of its net earnings for any calendar year in payment of the interest accruing and becoming payable upon such note in such year, and the balance of the principal amount of such note unpaid prior to April 15th in such year; provided, however, that the covenant herein made shall not be construed to relieve the Company from the payment on April 15th in such year of the installment specified for payment by the terms of said note nor of the regular interest payments in such year, likewise as specified

in said note. The term "net earnings" as herein used means the gross earnings from the business of the Company for such calendar year, less all current expenses of the business, all taxes
92 payable in such year by the Company and fixed charges other than those created by the note hereby secured.

Settlement for all amounts becoming payable under this provision in excess of the principal and interest payments absolutely required in the calendar year as of which such net earnings are determined shall be made by the Company to the Bank not later than April 15th of the succeeding year.

(2) The Company covenants and agrees that so long as the principal and interest hereby secured remain unpaid, it will furnish to the Bank quarterly statements of the financial condition and operations of the Company, and in addition, shall on or before April 15th in each year furnish to the Bank a detailed balance sheet as of the close of the preceding calendar year, audited by public accountants acceptable to the Bank. The Company shall also furnish to the Bank, at any time that it may so demand in writing, such information as may, in the Bank's judgment; be necessary and proper to give it sufficient ground for the taking or not taking of any action required or permitted hereunder, and shall permit the Bank or its agents, upon like demand at any time, to examine its premises, property, records and books of account, and the Company shall and will do everything in its power to facilitate such examination.

(3) The Company may, at its option, at any time so long as it is not in default under any of the provisions hereof, anticipate any part of the principal amount secured hereby. Any sums paid by the Company in excess of the principal and interest payments fixed by the terms of the note hereby secured, whether made voluntarily under the provisions of this paragraph or under the provisions of paragraph (1) of this Article I, shall be applied by the Bank in payment of the latest maturing installments specified in said note.

Article II

Possession of Company and Releases of Property

(1) Until the default of the Company hereunder, made and continued as herein provided, the Company may in
93 any manner not affecting the lien of this Indenture, or not inconsistent with any of the specific provisions hereof, possess, operate, manage, and use the premises and property, together with the rents, issues and profits thereof as if this Indenture had not been made. The Company may, anything herein to the contrary notwithstanding, in its sole and absolute

discretion and without approval of the Bank, sell, assign, mortgage, pledge or otherwise dispose of and freely use in its business, any or all of its present or hereafter acquired cash, accounts receivables, merchandise, supplies, current assets and other property not hereby conveyed and the proceeds of any such disposition thereof, and the Company may give good and unencumbered title to any of such assets to any purchaser, pledgee or other acquirer thereof in all respects as if this Indenture had never been executed.

(2) Until the default of the Company, made and continued as herein provided, the Company may sell, exchange or otherwise dispose of, free from the lien hereof, and without the consent of the Bank, all such machinery, tools, equipment or other like tangible property as may have become worn out or unfit for use, or which, in its judgment, shall no longer be useful or necessary for the maintenance of its business and operations. In the event of default so made and continued, such right may be exercised with the written consent of the Bank. Any replacements made by the Company of any such machinery, tools or equipment so disposed of, shall thereupon become subject to the lien of this Indenture.

(3) If the premises and property herein conveyed to the Bank shall at any time be in the possession of a Receiver or Trustee in Bankruptcy, lawfully appointed, the powers herein and by this Article conferred upon the Company shall be exercised by such Receiver or Trustee, with the approval of the Bank.

Article III

PARTICULAR COVENANTS OF THE COMPANY

(1) The Company covenants and agrees as follows:

94 The Company shall and will pay the principal and interest specified in the note hereby secured, duly and punctually according to the terms thereof and of this Indenture.

(2) The Company shall and will pay and discharge, as the same become due and payable, all real estate, income, profits, franchise, personal and other taxes, water rates, assessments and charges lawfully levied and imposed by the United States or by any State, County, Municipality or other taxing authority upon the properties herein conveyed, and including the franchises, earnings, income, profits and business of the Company, and it shall not suffer any mechanics, laborers, statutory or other lien to remain outstanding against such property or any part thereof, the lien whereof might or could be held to be prior to the lien of this Indenture. In case of the failure of the Company to cause

such taxes or liens above mentioned to be discharged, the Bank shall have the right to pay and discharge such taxes or liens, and thereupon the Company shall, upon demand, repay to the Bank the amount so paid by it with interest at the rate of six per centum (6%) per annum upon the amount thereof from the time the same was paid by the Bank, and the amount of any such payments by the Bank, together with interest thereon shall until repaid be equally secured by this Indenture of Mortgage.

(3) The Company shall and will, subject to the provisions of Article II hereof, keep and maintain the properties herein conveyed in good repair, working order and first class condition, and fully supplied with all requisite machinery, motive power and equipment, and shall renew and replace the same when necessary. It shall and will also take all necessary steps to comply with the laws of the United States, the State of Ohio and of such other States as may now or hereafter be applicable, so as to preserve, obtain and secure the rights and privileges now or hereafter necessary or proper for the preservation of its corporate existence and the conduct of its business and affairs, all
95 with the intent that the premises, fixtures, machinery and buildings herein conveyed shall at all times constitute an active, going and operating manufacturing plant and be fit and proper for the purposes for which they were designed.

(4) The Company shall and will at all times, so long as any of the principal and interest hereby secured remains unpaid, keep the premises herein conveyed, insured against loss or damage by fire, to an amount usual and customary in similar classes of property, and it shall and will pay all premiums upon the policies for such insurance. All such policies shall be made payable to the Bank as its interest may appear and the Company, when so requested by the Bank, shall deposit all such policies with the Bank. Should the Company fail at any time to keep its properties so insured, the Bank may insure the same to such amount, in which event the Company, upon demand, shall and will repay to the Bank the amount of all premiums paid by it with interest at the rate of six percentum (6%) per annum upon the amounts so paid from the time of payment by the Bank, and such payments with interest thereon shall, until paid, be equally secured by the lien of this mortgage.

(5) The Company covenants and agrees forthwith upon the execution hereof to cause this Indenture to be duly and properly filed and recorded as a mortgage of real estate and also as a chattel mortgage, and to pay or cause to be paid all filing and recording fees. The Company shall and will from time to time execute, renew and refile such chattel mortgages as counsel may advise to be necessary to comply with the provisions of the laws

of the State of Ohio, so as to vest and/or keep vested in the Bank a chattel mortgage lien upon all such chattels now owned by the Company or hereafter acquired.

(6) The Company shall and will from time to time upon request in writing by the Bank, its successors or assigns, make, execute, and deliver at its own expense, all such further acts, deeds, conveyances, transfers, assignments, and other instruments for the better assuring to the Bank, its successors or assigns, for the
96 purposes herein expressed, all and singular the present and hereafter acquired premises and property hereby conveyed, as the Bank, its successors or assigns, being advised by counsel, shall reasonably require.

(7) The Company will not suffer or permit any default to occur under this Indenture, but will faithfully observe and perform all the conditions, covenants, and requirements hereof.

Article IV

REMEDIES ON DEFAULT.

(1) If the Company shall make default in the payment of any interest or principal specified in the note hereby secured, and any such default shall have continued for thirty (30) days; or shall default in the performance of its covenants contained in Article I, Paragraph 1 hereof, and such default shall have continued for thirty (30) days; or shall make default other than one of the defaults herein specified, in respect of any condition, covenant, or agreement hereby required to be kept or performed by it, and such default shall have continued for sixty (60) days after written notice thereof to the Company from the Bank; or shall by decree of a court of competent jurisdiction be adjudicated a bankruptcy or insolvent, or by order of such court a receiver shall be appointed of the Company or of its property; or in any judicial proceeding by any party other than the Bank a judgment or order shall be entered by a court of competent jurisdiction for the sequestration of the property hereby conveyed or any part thereof, or the greater part of the Company's property shall be seized under any writ of attachment or other legal process and shall not be released or discharged therefrom by giving bond or otherwise within twenty (20) days; then, and in every such case, the Bank may declare the entire principal then unpaid immediately due and payable, and the same and the interest accrued thereon shall thereupon become and be immediately due and payable, anything in said bonds or herein contained to the contrary notwithstanding. In case the Company
97 shall fail upon demand to pay the same forthwith, the Bank shall be entitled to sue for and recover judgment for

the whole amount so due and unpaid with interest at the rate of six percentum (6%) per annum upon the overdue principal and installments of interest. No recovery of any such judgment by the Bank and no levy of execution upon any such judgment upon property subject to this Indenture or upon any other property shall in any manner or to any extent affect the lien of this Indenture upon any of the property subject hereto, or any rights, powers, or remedies of the Bank hereunder.

(2) No waiver by the Bank of any such default by the Company, whether such waiver be full or partial, shall extend to or be taken to affect any subsequent default or to impair the rights resulting therefrom.

(3) If one or more of the events of default hereinabove specified shall happen, the Bank may enter upon and sell at public auction to the highest bidder, in the Village of Sebring, State of Ohio, or at such other place or places as may be required by law, and after giving such notice as may be required by law, the whole of the property herein mortgaged, in separate parcels or as an entirety, as the Bank may, in its discretion, deem advisable. The Bank may make or deliver to the purchaser or purchasers of the trust estate, good and sufficient deed or deeds thereof in fee simple, free from any incumbrances hereby created, which sale, made as aforesaid, shall be a perpetual bar, both at law and in equity, against the Company and all other persons claiming or to claim the said property, or any part thereof, by, from, through or under the Company, and the Bank, its successors and assigns are hereby appointed the true and lawful attorneys irrevocable of the Company, in its name and stead, for such purpose to execute all necessary acts of conveyance, assignment and transfer, the Company hereby ratifying and confirming all that its said attorneys shall lawfully do by virtue hereof. Any surplus remaining out of the proceeds of such sale after proper allowance for all expenses thereof, including attorney and
98 counsel fees, all other expenses or advances which may have been made or incurred by the Bank in respect to such property, the satisfaction of charges and liens prior to the lien of this Indenture on said property, and the full payment of the unpaid principal and interest upon this note hereby secured, shall be transferred and paid over to the Company, its successors or assigns, for its or their sole use and benefit.

(4) In case of any sale hereunder, the Bank may bid for and purchase the property sold, and upon compliance with the terms of sale, may hold and retain or dispose of such property without further accountability therefor to the Company.

(5) If one or more of the events of default shall happen, the Bank may, personally or by its attorney or agent, enter into and upon all and singular the property herein mortgaged and take possession thereof and wholly exclude the Company and its agents therefrom, and thereafter hold, use or operate the same as the Company could or might do if this Indenture had not been made, with the right to collect and receive all income, rents, issues and profits of the same, and after deducting the expense of operating such property and the cost of all materials, supplies, repairs, replacements and improvements, and payments on account of insurance, taxes or liens prior to the lien of this Indenture on the said property, or any part thereof, apply the remainder of such income in payment of any interest or principal then due and unpaid as specified in the note hereby secured. This power of entry may be exercised as often as occasion therefor shall arise until the principal and interest hereby secured have been fully paid.

(6) It is expressly understood that the rights of entry and sale and suit hereinbefore granted are intended as cumulative remedies, additional to each other and to all other remedies allowed by law, and that the same shall not be deemed in any manner whatever to deprive the Bank of any legal or equitable remedy by judicial proceeding or proceedings consistent with the provisions of this Indenture.

99 OCTOBER 15, 1936.

The conditions of the within mortgage have been complied with and the same is hereby satisfied and discharged.

CENTRAL NATIONAL BANK OF CLEVELAND,
Successor by change of name to
CENTRAL UNITED NATIONAL BANK OF CLEVELAND,

(Signed) By: H. R. HARRIS,
Vice President.

(Signed) ANTHONY POSS,
Trust Officer.

Recorded: Jan. 13, 1937.
JAMES M. ELLIOTT, *Recorder*
Mahoning County, Youngstown, Ohio.

(7) In case the Bank shall have proceeded to inforce any right under this Indenture by foreclosure, entry or otherwise, and such proceeding shall for any reason have been discontinued or abandoned, or shall have been determined adversely to the Bank, then and in every such case the Company and the Bank shall

be restored to their former position and rights hereunder in respect of the said premises, and all rights, remedies and powers of the Bank shall continue as though no such proceedings had been taken.

ARTICLE V

Defeasance

If the Company, its successors, or assigns shall well and truly pay, or cause to be paid, the whole amount of the principal and interest due upon the note hereby secured as in said note agreed to be paid, and if all the charges of the Bank hereunder or concerning the properties herein mortgaged shall have been paid or satisfied by the Company, and the Company shall have fully performed all its covenants and agreements hereunder, then and in that case the Company shall be entitled to have this Indenture satisfied and discharged, and all the properties hereby conveyed shall thereupon revert to the Company, or to its successors and assigns, and the estate, right, title and interest therein of the Bank, its successors and assigns, shall wholly cease, determine and become void. The Bank shall thereupon execute to the Company or to its successors and assigns, at the latter's cost and expense, such satisfaction, release, re-assignment and reconveyance as may be reasonably required to satisfy and discharge these presents, and shall pay over and deliver to the Company, or its successors or assigns, all money then in the hands of the Bank received by it under any provision of this Indenture, and all property held by it under any of the provisions hereof.

In witness whereof, The Strong Manufacturing Company, party of the first part, has caused its corporate name to be hereunto subscribed by its President, and its corporate seal affixed, attested by its Secretary; and Central United National Bank of Cleveland, Trustee, party of the second part, has caused its corporate name to be hereunto subscribed by its President or Vice-President and its corporate seal affixed, attested by its Cashier or an Trust Officer, as of the day and year first above written.

THE STRONG MANUFACTURING COMPANY,

[SEAL] By: (Signed) W. U. PFAEFFLI,
President.

Attest:

(Signed) T. F. SHAFFER,
Secretary.

Signed in the Presence of:
(Signed) R. A. BISHOP.
(Signed) W. N. GATES.

[SEAL] CENTRAL UNITED NATIONAL BANK,
Trustee,

By: (Signed) H. R. HARRIS,
Vice-President.

Attest:

(Signed) ANTHONY POSS,
Trust Officer.

(Signed) S. E. HART.
(Signed) J. L. MUNTYAN.

101 STATE OF OHIO,
Mahoning County, ss:

Before me, a Notary Public in and for the said County, personally came The Strong Manufacturing Company, a Corporation, by W. U. Pfaeffli, its President, and T. F. Shaffer, its Secretary, whose names respectively are signed to the foregoing instrument and who severally acknowledged the signing and execution of the said instrument for themselves respectively and for and on behalf of said Company, and acknowledged that they have affixed the corporate seal of said Company to said instrument and otherwise executed the same by direction of a Resolution of the Board of Directors of said Company, and who acknowledged that the same in all respects is their free act and deed as such officers respectively, and the free act and deed of said corporation.

In Testimony Whereof, I have hereunto set my hand and official seal at Youngstown, Ohio, this 18th day of April A. D. 1932.

[SEAL] (Signed) ARTHUR MORGAN,
Notary Public.

ARTHUR MORGAN,
Notary Public.

My commission expires July 8, 1932.

STATE OF OHIO,
Cuyahoga County, ss:

Before me, a Notary Public in and for the said County, personally came Central United National Bank, a banking corporation, by H. R. Harris, its Vice President, and Anthony Poss, its Trust Officer, whose names respectively are signed to the foregoing instrument and who severally acknowledged the signing and execution of the said instrument for themselves respectively and for and on behalf of said Bank, and acknowledged that they

have affixed the corporate seal of said Bank to said instrument and otherwise executed the same upon authority duly granted them, and acknowledged that the same in all respects is
102 their free act and deed as such officers respectively, and the free act and deed of said corporation.

In Testimony Whereof, I have hereunto set my hand and official seal at Cleveland, Ohio, this 18th day of April A. D. 1932.

[SEAL] (Signed) WILLIAM N. GATES,
Notary Public.

131 In United States Circuit Court of Appeals

Statement of points

Filed October 24, 1940

Comes now the petitioner on review herein and makes this concise Statement of Points on which he intends to rely on the review herein, to-wit:

The United States Board of Tax Appeals erred:

1. In holding and deciding that there is a deficiency in income tax for the year 1936 in the amount of $2,133.63.

2. In failing to sustain the deficiency in income tax determined by the Commissioner for the year 1936 in the amount of $14,776.89 less the proper reduction of said amount to reflect the adjustments agreed upon by the parties at the hearing before the Board of Tax Appeals.

3. In holding that "we are of the opinion that the 'application' to the indebtedness of the designated portion of the earnings may, for present purposes, be considered to be called for by the contract 'as of' the taxable year, Michigan Silica Co., 41 B. T. A. 511, 515, and, therefore, to constitute the irrevocable setting aside contemplated by the statute."

4. In holding that the credit should have been allowed and that the Commissioner's determination to the contrary is overruled.

5. In that its opinion and decision are not supported by its findings of fact and are contrary to law.

(Signed) J. P. WENCHEL,
CAR
Chief Counsel,
Bureau of Internal Revenue.

Service of a copy of the above statement of points is hereby acknowledged this 24th day of September, 1940.

(Signed) ARTHUR MORGAN,
(Signed) RAYMOND S. POWERS,
Counsel for Respondent on Review.

132 Before United States Board of Tax Appeals

Designation of portions of record, proceedings, and evidence to be contained in record on review

Filed October 24, 1940

To the Clerk of the United States Board of Tax Appeals:

You will please prepare, transmit, and deliver to the Clerk of the United States Circuit Court of Appeals for the Sixth Circuit, copies duly certified as correct of the following documents and records in the above-entitled cause, in connection with the petition for review by the said Circuit Court of Appeals for the Sixth Circuit, heretofore filed by the Commissioner of Internal Revenue:

1. Docket entries.
2. Pleadings:
   (a) Petition,
   (b) Answer to Petition.
3. Board's findings of fact, opinion, and decision.
4. Petition for review.
5. Notices of filing.
6. Statement of points.
7. This designation.

(Signed) J. P. WENCHEL,
CAR
Chief Counsel,
Bureau of Internal Revenue.

Service of a copy of the within designation of portions of record, proceedings, and evidence to be contained in record on review is hereby admitted this 1st day of October, 1940.

(Signed) RAYMOND S. POWERS,
Counsel for Respondent on Review.

133 [Clerk's Certificate to foregoing transcript omitted in printing.]

Before United States Board of Tax Appeals

Order Enlarging Time

On motion of counsel for the petitioner, it is

Ordered: That the time for preparation and transmission of the record *sur* petition for review of the above entitled proceed-

ing in the United States Circuit Court of Appeals for the Sixth Circuit, be and it is hereby extended to December 13, 1940.

[SEAL] (Signed) C. R. ARUNDELL,
Member.

Dated: Washington, D. C., October 9, 1940.

Now, November 27, 1940, the foregoing is certified from the record as a true copy.

(Signed) B. D. GAMBLE, *Clerk*,
U. S. Board of Tax Appeals.

134 In United States Circuit Court of Appeals
for the Sixth Circuit

Cause argued and submitted

November 11, 1941

Before HAMILTON, MARTIN, AND MCALLISTER, JJ.

This cause is argued by Bernard Chertcoff for Petitioner and by Raymond S. Powers for Respondent and is submitted to the court.

In United States Circuit Court of Appeals

Decree

Entered: December 9, 1941

Appeal from the United States Board of Tax Appeals.

This cause came on to be heard on the transcript of the record from the United States Board of Tax Appeals and was argued by counsel.

On Consideration Whereof, It is now here ordered, adjudged, and decreed by this Court that the order or decree of the said Board of Tax Appeals in this cause be and the same is hereby affirmed.

136 In United States Circuit Court of Appeals, Sixth
Circuit

No. 8829

COMMISSIONER OF INTERNAL REVENUE, PETITIONERS

v.

THE STRONG MANUFACTURING COMPANY, RESPONDENT

On petition for Review of Decision of the United States Board of Tax Appeals.

Opinion

Filed Dec. 9, 1941

Before HAMILTON, MARTIN, and MCALLISTER, Circuit Judges.

MCALLISTER, Circuit Judge: The Commissioner of Internal Revenue filed his petition for review of the decision of the Board of Tax Appeals that The Strong Manufacturing Company was entitled to a credit on its 1936 surtax on undistributed profits by virtue of Section 26 (c) (2) of the 1936 Revenue Act.

The above mentioned section of the act, in so far as here applicable, provided that credits on undistributed profits shall be allowed to a corporation to the extent that earnings and profits are required to be irrevocably set aside within the taxable year for the discharge of a debt, provided they are so required to be set aside by written contract executed by the corporation prior to May 1, 1936. The taxpayer, an Ohio corporation, purchased its plant and equipment from the Central United National Bank of Cleveland about April 15, 1932, for the sum of $50,000. The purchase price was evidenced by a note, secured by a mortgage executed by the taxpayer to the bank, providing for payment in eight installments of varying amounts, due on April 15, 1934, and on the same date of each year thereafter. Stipulations
137 in the note set forth that the corporation could anticipate unpaid installments in whole or in part; and it was further provided in the note:

"In addition The Strong Manufacturing Company shall apply forty percent (40%) of its net earnings in and for any calendar year beginning January 1, 1934, upon the unpaid balance of said purchase price, provided that the amount so applied shall never be less than the installment of the purchase price specified for payment in such year, all as more fully set forth in said mortgage deed."

The mortgage set forth:

"The Company covenants and agrees that until the principal and interest of the note hereby secured shall have been fully paid and beginning on January 1st, One Thousand nine hundred thirty four, the Company will apply for per centum (40%) per annum of its net earnings for any calendar year in payment of the interest accruing and becoming payable upon such note in such year, and the balance of the principal amount of such note unpaid prior to April 15th in such year; provided, however, that the covenant herein made shall not be construed to relieve the Company from the payment on April 15th in such year of the installment specified for payment by the terms of said note nor

of the regular interest payments in such year, likewise as specified in said note."

It was further provided that if the corporation defaulted, and such default continued for thirty days, the bank could declare the entire balance immediately due and payable; and no waiver of any default by the bank should affect any subsequent default.

In 1934, the taxpayer obtained from the bank a written extension on a then due installment of $2,000, principal, and $3,500, interest, on the note and mortgage. The extension was on the specific condition that it should not be considered a waiver of any subsequent defaults; and the bank did not waive or make any concession in respect to the covenants of the note and mortgage requiring the taxpayer to apply 40% of its net earnings in payment of the debt.

During 1936, the taxpayer made payments out of profits on the principal of the note, in various months, aggregating $46,500,
138 whereupon the bank waived payment of a small amount of principal and some interest, and accepted such payments in full for the balance due on the note and mortgage. The taxpayer claimed that these aggregate payments on the note and mortgage, which it made in 1936, are entitled to credit on undistributed profits and that by virtue of the provisions of the act, it is not taxable thereupon.

The relevant provisions of the statute read:

"In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

"(c) Contracts Restricting Payment of Dividends.

"(2) Disposition of Profits of Taxable Years.—An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressively deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been so paid or set aside. For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits. As used in this paragraph, the word 'debt' does not include a debt incurred after April 30, 1936."

Petitioner insists that the contract did not require that respondent irrevocably set aside a portion of its earnings of the taxable year within that year for the discharge of the debt; and that in-

asmuch as the contract did not come within the required terms of the statute, respondent is entitled to no credit for the payments made.

The question, therefore, before us for determination, is whether the payments made by the corporation upon its debt are taxable as undistributed profits, or whether it is entitled to credit on the basis of earnings and profits "irrevocably set aside within the taxable year for the discharge of a debt."

In brief, the statute allows a deduction on the tax in question where a contract requires a corporation to set aside irrevocably a portion of its profits within the taxable year for the payment of a debt. In this case, the contract of the corporation re-
139 quires it to apply 40% of its net earnings for any calendar year to pay the balance of the debt, or a portion thereof, in that year. It is contended on behalf of the Commissioner that, because settlement on the debt could be made in the succeeding year, the contract does not require the irrevocable setting aside of such profits in the year in which they are earned. On the other hand, respondent corporation contends that, inasmuch as it is bound to "apply" its profits for the calendar year to the payment of the balance of the debt remaining unpaid in that year, this obligation comes within the requirement of the statute and constitutes a contract to set aside irrevocably a portion of its profits to the payment of a debt within a taxable year.

The phrase "set aside" has various meanings and connotations. One is "reserve"; and "reserve" is defined as "to keep back," "to retain," "to keep in store for future or special use," and "to retain or hold over to a future time"; "irrevocable" is defined as "incapable to being recalled or revoked." Webster's New International Dictionary. To sustain the respondent, we are required, however, to construe the statute to the effect that "to set aside" means: to place in a separate fund; to carry under a separate entry or in a separate account; to transfer to a trustee; or some equivalent act of physical separation or appropriation of the profits, for the payment of the debt. If the statute provided that the corporation would be entitled to credit by virtue of a provision of a contract requiring it to keep, retain, or reserve, without right of revocation, a portion of its profits within the taxable year for the discharge of a debt, it would seem that respondent would be entitled to credit on the tax. Whether such a construction can properly be given the statute, and whether the conclusion reasonably follows that respondent is entitled to credit, depends upon accepted rules of statutory construction.

The construction of the statute for which the Commissioner contends would forbid credits to any corporation whose business

was such that it could not definitely ascertain its profits on the last day of the year; and this would exclude from such benefits all corporations that were obliged to take an inventory that could not be completed within the year. Obviously, the result would be to deny such credits to practically all manufacturing and merchandising corporations, and to admit only those financial companies whose earnings and profits are generally susceptible of immediate computation. This would be unjust. Payment
140 of the high surtax would work an unusual hardship on a corporation that was required, under penalty of mortgage foreclosure, to pay such earnings on its mortgage debts. Furthermore, the result of sustaining the claim of the Commissioner would be to require payment of a surtax on undistributed profits where there were no undistributed profits, by reason of the fact that the earnings, under inexorable conditions of a contract, were required to be paid upon a debt. This would be unjust and result in a burden of an especial and unusual nature.

Where a particular construction of a statute will produce inequality and injustice, that view is to be avoided if another and more reasonable interpretation is present in the statute. Constantine v. United States, 75 Fed. (2d) 928, Aff., 296 U. S. 287. The strict letter must yield to the evident spirit and purpose when necessary to give effect to the intent of Congress; Fleischmann Const. Co. v. United States, to use of Forsberg, 270 U. S. 349; for a thing which is within the intention of the statutes is as much within the statute as if it were within the letter, and a thing which is within the letter of the statute is not within the statute, unless it is within the intention of the maker; Northwestern Mutual Life Insurance Co. v. Gridley, 100 U. S. 614; and where the meaning is uncertain, a statute will be construed so as to avoid unnecessary hardship. Burnet v. Guggenheim, 288 U. S. 280. The duty of the court, being satisfied with the intention of the legislature, is to give effect thereto and not to defeat it by adhering too rigidly to the mere letter of the statute or to technical rules of construction. Oates v. First National Bank, 100 U. S. 239.

In the application of taxing statutes, substance and not form should control; Sanborn v. Commissioner of Internal Revenue, 88 Fed. (2d) 134, cer. den., 301 U. S. 700; and such laws should be construed and applied with a view of avoiding, as far as possible, unjust consequences. Farmers Loan and Trust Co. v. State of Minnesota, 280 U. S. 204.

In ascertaining the purpose of the legislature in enacting a statute, the court may examine its title and the legislative scheme or plan by which the object of the act is to be carried out; United

States v. Katz, 271 U. S. 354; and the intention is to be ascertained, not by taking a word or clause from its setting and viewing it apart, but by considering it in connection with the context, general purpose of the statute, occasion and circumstances of its use, and other appropriate tests for the ascertainment of the legislative will. Helvering v. Stockholms Enskilda Bank,
141 293 U. S. 84. The purpose of all statutory construction is to give effective to the legislature's intention and, hence, no rule of strict construction, which will defeat a statute's purpose, can be applied to its bare language.

The general title of the 1936 Revenue Act sets forth its purpose to "provide revenue, equalize taxation, and for other purposes." The subtitle of Section 26 (c) of the act reads: "Contracts restricting payment of dividends," and the title of Subsection 26 (c) (2) is: "Disposition of profits of taxable year." In the message of the President to Congress with respect to the enactment of the statute, the provisions of which are under consideration, he directed attention to a form of tax for the purpose of removing inequalities in the tax system, and mentioned, in this regard, the accumulation of surplus in corporations and the freedom of such undistributed corporate income from surtax. Message of President to Congress, March 3, 1936. In the report of the Ways and Means Committee of the House of Representatives on the Revenue Bill of 1936, after quoting the message, the Committee stated that the President had requested Congress to raise additional revenue by some form of undistributed profits tax, and that the Committee recognized that the greatest defect in the system of taxation at that time lay in the fact that surtaxes on individuals were avoided by impounding income in corporate surpluses. It was further recommended that corporations should not be permitted to withhold from the beneficial shareholders unneeded corporate income at the expense of the revenue of the United States and to the detriment of the shareholders, H. R. Rept. No. 2475, 74th Congress, Sec. Sess. From these proceedings, the legislative intention and the general purpose of the act, are obvious. It was sought to prevent corporations from accumulating tax free surplus arising out of their failure to distribute the earnings to shareholders, with the result that the Government could not tax such individuals. The headings in the statute, above referred to, indicate the intent to grant credit on surtax imposed on undistributed profits to the extent that such profits were not declared as dividends by reason of a contract requiring a different disposition of such profits.

It is necessary to keep in mind that taxation is an intensely practical matter and the substance of the thing done, and not

the form it takes, must govern. Commissioner of Internal Revenue v. Ashland Oil and R. Co., 99 Fed. (2d) 588 (C. C. A. 6); and that common sense interpretation is the safest rule to
142 follow in the administration of income tax laws. "Gross income and deductions flow from trade, commerce and dealings in property carried on in the ordinary business way and in the determination of taxes, men should measure both by ordinary, every-day business standards." Rhodes v. Commissioner of Internal Revenue, 100 Fed. (2d) 966, 969 (C. C. A. 6).

With reference to the object of the statute to equalize taxation, it cannot be said that the resulting inequality of taxation, as contended for on behalf of the Commissioner, is consonant with such expressed purpose. There appears to be no reason founded on principles of fair dealing, accounting methods, ordinary business practice, or common sense, that would justify the unreasonable, capricious, and discriminatory plan of taxation here sought to be established as the statutory law; and, in this case, in the absence of a clearly expressed intention to the contrary, it must be held that Congress did not intend to work inequality, injustice, and hardship, nor was it intended that the statute would have this meaning and effect.

We are of the opinion that, in accordance with the legislative intent, the contract, requiring the corporation to "apply" 40% of its earnings for any calendar year to the payment of indebtedness in such year, is encompassed by the requirement of Section 26 (c) (2) of the Revenue Act of 1936; and such application is equivalent to setting aside, irrevocably, profits within the taxable year for the discharge of a debt, and entitles the taxpayer to credit.

That the profits, which were required to be applied to the indebtedness, could not be computed until after the taxable year, casts no doubt upon the conformity of the contract to the requirements of the statute. Where the law requires debts to be charged off within the taxable year, in order to receive deductions, the statutory language is construed to allow deductions for debts *physically* charged off in the first months of the succeeding year, in recognition of practical business necessities; and it is held that Congress did not intend that there should be any essential departure from the usual course of business in making book entries in order to comply with tax laws. *Hamlen* v. *Welch*, 116 Fed. (2d) 413 (C. C. A. 1); *Kentucky Rock Asphalt Co.* v. *Helburn*, 20 Fed. Supp. 364, Aff., 108 Fed. (2d) 779 (C. C. A. 6). Like principles are applicable to the ascertainment of profits, and credit for applications thereof on indebtedness.

143 The claim is advanced that because the duty to make certain regular stipulated payments did not, by contract,

depend on the existence of earnings, therefore, the taxpayer is not entitled to credit for such payments on the indebtedness. But the taxpayer is only seeking credit for that amount of profits which, in accordance with the contract, it claims it irrevocably set aside for payment of the debt. If the contract, with respect to the setting aside of such profits, conforms to the requirement of the statute, it is immaterial that the portion of profits so set aside for the indebtedness, exceeded the stipulated sum which was required to be paid, regardless of profits. That such required payment was included in the percentage of profits required to be set aside, has no bearing upon the right to credit.

We are mindful of the fact that since the argument in the instant case, in *Antietam Hotel Corp.* v. *Commissioner of Internal Revenue*, — Fed. (2d) — (C. C. A. 4) (decided November 10, 1941), it was held "that as an indispensable condition precedent to the allowance of the credit, the contract must in terms require that a part of the earnings and profits of the taxable year be irrevocably set aside within the taxable year." We do not arrive at the same conclusion, for we do not find from the language of the statute that the contract must require the earnings to be irrevocably set aside, *in terms*. With regard to the case of *Helvering* v. *Moloney Electric Co.*, 120 Fed. (2d) 617 (C. C. A. 8), in which it was held that the taxpayer was not entitled to credit under the section of the statute in question, it appears that there was no showing in that case what the earnings of the corporation were, when the payment on the indebtedness was made, or whether the payment was ever made because of any contract requirement; and these circumstances were of paramount significance in that adjudication. Confronted by entirely different facts, it would appear that further discussion, for the purpose of distinguishing the cited case, would be fruitless.

In accordance with the foregoing, the decision of the Board of Tax Appeals is affirmed.

144 [Clerk's Certificate to foregoing transcript omitted in printing.]

145 Supreme Court of the United States

Order allowing certiorari

Filed April 6, 1942

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Sixth Circuit is granted.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

146 In Supreme Court of the United States

Stipulation

Filed May 16, 1942

Subject to this Court's approval, it is hereby stipulated and agreed by and between the attorneys for the respective parties thereto, that for the consideration of this case on writ of certiorari, the printed record may consist of the following:

1. The material contained in the printed transcript of record (consisting of 141 pages) used for the purposes of the petition for writ of certiorari herein, omitting, however, the following:

(a) The entire transcript of testimony, pages 31–64, except the testimony of Sidney J. Collins at pages 52–57.

(b) Petitioner's Exhibit 1, appearing at pages 65–83.

(c) Petitioner's Exhibit 4, appearing at pages 102–105.

(d) Petitioner's Exhibit 5, appearing at pages 107–129.

2. This stipulation.

147 It is further agreed that either party may make reference in brief or argument to any portion of the record which is not included in the printed record prepared as aforesaid.

CHARLES FAHY,
Charles Fahy,
Solicitor General of the United States,
Counsel for Petitioner.

Dated this 11th day of May, 1942.

RAYMOND S. POWERS,
Counsel for Respondent.

Dated this 13th day of May, 1942.

File No. 46345. U. S. Circuit Court of Appeals, Sixth Circuit. Term No. 41. Guy T. Helvering, Commissioner of Internal Revenue, petitioner, vs. The Strong Manufacturing Company. Petition for a writ of certiorari and exhibit thereto. Filed March 5, 1942. Term No. 41, O. T. 1942.

U. S. GOVERNMENT PRINTING OFFICE: 1942